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In the

Supreme Court of the United States

October Term, 1942

No. 766

VIRGINIAN HOTEL CORPORATION
OF LYNCHBURG,
Petitioner,

vs.

GUY T. HELVERING, Commissioner of
Internal Revenue,
Respondent.

On Writ of Certiorari to the United States Circuit Court
of Appeals for the Fourth Circuit

BRIEF ON BEHALF OF PITTSBURGH BREWING COMPANY AS *AMICUS CURIAE*

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Amicus Curiae.

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Preliminary Statement

This brief is filed by the Pittsburgh Brewing Company as *amicus curiae* with the consent of both parties to the proceedings in accordance with the rules of the Court.

The judgment of the Circuit Court of Appeals for the Fourth Circuit in *Guy T. Helvering, Commissioner of Internal Revenue v. Virginian Hotel Corporation of Lynchburg*, 132 Fed. (2d) [illegible], presents a conflict with that rendered by the Circuit Court of Appeals for the Third Circuit in *Pittsburgh Brewing Company v. Commissioner of Internal Revenue*, (1939), 107 Fed. (2d) 155. This Court has granted the application of the petitioner herein for a writ of certiorari. 87 L. ed. 77[illegible].

Question Presented

Is a taxpayer estopped to correct an erroneous deduction for depreciation reported in a loss year where he has not profited by his mistake and the Treasury has suffered no loss thereby? In other words, must a taxpayer's basis for determining gain or loss on the sale of depreciable assets and for computing annual depreciation allowances be reduced by the erroneous excess of depreciation deductions reported in loss years.

Statute Involved

The statute involved is the Revenue Act of 1938 (52 Stat. 447), Section 23(1) and 23(n), 113(b)(1)(B) and 114(a). These sections provide as follows:

> "Sec. 23. Deductions From Gross Income.
>
> In computing net income there shall be allowed as deductions:
>
> * * * *
>
> (1) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *
>
> * * * *
>
> (n) *Basis for depreciation and depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.
>
> * * * *
>
> Sec. 113. Adjusted Basis for Determining Gain or Loss.
>
> * * * *
>
> (b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (2), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *"

Statement

The case arose in the U. S. Board of Tax Appeals (now The Tax Court of the United States) and was tried on a stipulation of facts. In substance, the agreed facts presented the following situation which frames the disputed issue of the case:

The petitioner operated a hotel and, in connection therewith, owned various depreciable assets. From June 1, 1927 to December 31, 1938 the petitioner and its predecessor in interest had taken depreciation thereon at 15% a year on carpets and 10% a year on all other equipment. After examining petitioner's return for the year 1938, respondent determined that these depreciation rates were clearly excessive, that the proper rates were 8% on carpets and 5% on all other equipment. The Commissioner conceded that the erroneous rates used by petitioner (approximately 100% greater than that properly allowable on the carpets and 100% greater than the proper rate on the other equipment) were excessive on the known facts in all prior years as well. However, although petitioner had had loss years for 1931 to 1936, inclusive, in which the mistake did not profit the petitioner or prejudice the respondent in view of the fact that petitioner had no tax to pay in any event, respondent insisted that the mistake was beyond correction. Consequently, he determined that the basis of petitioner's as-

sets for the computation of depreciation must be reduced not only by the amount of the properly allowable depreciation for the loss years (1931-1936, inc.) but also the erroneous excess which was mistakenly reported in the said years.

Respondent took the position that where an amount of depreciation is reported on a return, the taxpayer's basis is forever reduced thereby even if the amount so reported is an obvious error—a palpable mistake in the rate, an error in the computation of basis or even a mathematical error in computing the item to be entered on the return—notwithstanding that the taxpayer is not estopped to make the correction. His theory was that the erroneous deduction was "allowed" to the taxpayer by the mere filing of the return containing the item and respondent's inaction with respect thereto.

In the resulting computation based upon respondent's theory, petitioner's basis, adjusted by all deductions reported in prior years, is then spread ratably over the correct remaining useful life of the assets.

The Board of Tax Appeals, following the decision rendered by the Third Circuit in the Pittsburgh Brewing Company case, sustained the taxpayer's contention that basis should not be reduced by the erroneous excess of depreciation reported in the loss years where on the then known facts the amounts reported were excessive (The unreported memorandum opinion of the Board is printed in the record herein at p. 34).

Summary of Argument

The depreciation provisions of our tax laws should be construed in accordance with the expressed opinions of the Congress at the time of the enactment. The language of the particular section under review should be inter-

preted in the accepted sense of its terms and in the light of the evil which it was designed to correct. The Committees of Congress which framed the section stated that the purpose of the amendment to Section 113(b)(1)(B) was to preclude the possibility of taxpayers' obtaining double deductions through depreciation allowances, although the law was then admittedly adequate to prevent such a possibility. The scope of the section should, therefore, not be extended so as to prevent the rectification of errors reported in loss years where, on accepted principles of law, no estoppel lies.

ARGUMENT

I

Under settled principles of law a taxpayer who reports an erroneous deduction in his return in a loss year is not barred from correcting his mistake where he has not profited thereby and the Treasury has suffered no loss.

Stripped of all collateral issues, this case presents a comparatively simple tax problem. Stated briefly, the issue is whether a taxpayer is irrevocably charged with erroneous depreciation deductions reported on his returns where he has not profited by his mistakes and where the Commissioner has suffered no loss therefrom. In other words, must a taxpayer's base be reduced by the excessive amounts of depreciation so reported both for the purpose of computing annual depreciation deductions and for determining gain or loss on sale of depreciable assets.

Much has been said in the opinion of the Court below and in other decisions recently rendered concerning the application of the so-called "tax benefit theory" to the

issue here involved.[1] We respectfully submit that the question presented on this appeal is not bottomed on the subject of tax benefit at all. On the contrary, we are here concerned with the simple question whether the principles of law applicable to the adjustment in tax returns of errors made in the reporting of expenses and other deductions shall not be available in the case of errors made in the reporting of depreciation deductions.

In the instant case it was stipulated before the Board of Tax Appeals that during all of the years in question the petitioner had employed erroneous rates of depreciation. On the known facts in the said years the rates used were admittedly excessive. Since the petitioner did not profit by its mistakes is it estopped to adjust its base by eliminating the excessive credits to its depreciation reserve?

In the last analysis the problem projected by the language "allowed (but not less than amount allowable)", contained in Section 113(b)(1)(B) is one of avoidance of double deductions.[2] The history of the legislative amend-

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[1] *Helvering* v. *Virginian Hotel Corporation of Lynchburg* (C. C. A. 4), 132 Fed. (2d) 909.

Don Lee, Inc. v. *U. S.* (D. C. Cal.) 42 F. Supp. 884.

Com'r. of Internal Revenue v. *Kennedy Laundry Company* (C. C. A. 7), decided February 15, 1943.

[2] *Mertens "Law of Federal Income Taxation"*, Vol. 3, pp. 637-8 says in this connection:

> "The question has arisen whether the basis under the 1932 and subsequent acts must be reduced not only by the depreciation allowable, but also by the excess deducted on the return where the taxpayer by reason of other deductions derives no tax benefit in the form of reduced net income by reason of the excess deducted, in other words, where the net income is zero or less regardless of the excess deducted. The decision in a recent case was that the basis in such a situation was not to be further reduced over and above the depreciation allowable, by the excess claimed on the return. This seems sound, since the purpose of compelling the taxpayer to reduce his basis by the amount allowed is to prevent the taxpayer from enjoying a double deduction as clearly appears from the Congressional Committee Reports."

ments to the depreciation sections of our revenue laws furnishes ample evidence of the Congress' efforts to plug the loopholes in that branch of the law. We shall not here review this legislative history for the reason that adequate treatment of the subject has been given thereto in the petitioner's brief. That analysis clearly demonstrates that in the successive changes of the phraseology pertaining to depreciation adjustments the Congress was struggling to achieve a provision under which taxpayers would be afforded an opportunity to recover their capital investments and the Treasury Department would be entitled to recover a just tax. The change from the words "previously allowed" as contained in the Revenue Act of 1924[3] to "allowable" as contained in the Revenue Act of 1926[4] and finally to the words "allowed (but not less than the amount allowable)", as contained in the Revenue Act of 1932,[5] was the result of the studied attempt by the Congress to eliminate the difficulties which experience in the administration of this subdivision of our tax laws had produced.

The report of the Senate Finance Committee (Sen. Rep. 665, p. 29, 72 Cong. 1st Sess.), issued in connection with

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[3] Sec. 202(b), Revenue Act of 1924 (43 Stat. 253).

[4] Sec. 202(b), Revenue Act of 1926 (44 Stat. 9).

[5] Sec. 113(b)(1)(B) Revenue Act of 1932 (47 Stat. 169).
This section reads as follows:

"Sec. 113. Adjusted Basis for Determining Gain or Loss.

* * * * *

(b) *Adjusted basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

* * * * *

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. * * *"

the Revenue Act of 1932, is specific in its statement of the reasons for the amendment to Section 113(b)(1)(B).[6] The Committee acknowledged that the section as amended was merely a codification of existing law. When it said: "While the Committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility", it made it quite clear that it was not changing or adding anything to the law. It was merely inserting phraseology, consistent with the law as it then understood it to be, which would minimize or eliminate entirely the annoyances and inconveniences resulting from attempts by taxpayers to circumvent the law.

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[6] *The Senate Finance Committee Report* (Sen. Rep. 665, p. 29, 72nd Cong., 1st Sess.) contains the following statement:

"In subparagraph (B), (of Sec. 113(b)(1)), relating to depreciation, etc., for the period since February 28, 1913, the bill requires that adjustment be made to the extent allowed (but not less than the amount allowable) instead of 'by the amount * * * allowable' as in the prior act. The Treasury has frequently encountered cases where a taxpayer, who has taken and been allowed depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact 'allowable' were much less. By this time the government may be barred from collecting the additional taxes which would be due for the prior years upon the strength of the taxpayer's present contentions. The Treasury is obliged to rely very largely upon the good faith and judgment of the taxpayer in the determination of the allowances for depreciation, since these are primarily matters of judgment and are governed by facts particularly within the knowledge of the taxpayer and the Treasury should not be penalized for having approved the taxpayer's deductions. While the Committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility.

"Your committee has not thought it necessary to include any express provision against retroactive adjustments of depreciation on the part of the Treasury as the regulations of the Treasury seem adequate to protect the interests of taxpayers in such cases. These regulations require the depreciation allowances to be made from year to year in accordance with the then known facts and do not permit a retroactive change in these allowances by reason of the facts developed or ascertained after the years for which such allowances are made."

It is difficult to read the report of the Senate Finance Committee, in the light of the legislative history of Section 113(b)(1)(B), and reach any other conclusion but that in the enactment of this section the Congress was aiming to prevent double deductions. Congress was not laying down a new set of legal principles which would apply differently to depreciation deductions than to deductions for any ordinary business expenses. Under the Revenue Act of 1926, which provided that basis be diminished by depreciation deductions which have been "allowable", a taxpayer who deducted a greater amount of depreciation than was properly allowable would nevertheless be bound by the excess depreciation if such excess had off-set taxable income. The doctrine of estoppel would serve to prevent him from recovering that part of his capital investment again in a later year. Since the regulations and the authorities had for many years provided that depreciation allowances were granted as a means of returning one's capital investment tax-free, any attempt by a taxpayer to take a double deduction by eliminating an erroneous depreciation deduction which had off-set taxable income in a prior year would be thwarted by settled principles of law.[7] While the Senate Finance Committee recognized this fact, it nevertheless preferred to have the Revenue Act "specifically preclude any such possibility."

Nothing in the legislative history of depreciation deductions indicates any intention on the part of the Congress to deny to taxpayers the right to rectify mistakes in the determination or computation of depreciation. In approaching this phase of the problem, however, we must be certain to distinguish between errors based upon the known facts in the prior loss years when the erroneous rates were used and the correction of rates resulting from

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[7] *U. S.* v. *Ludey*, 274 U. S. 295.
Cameron v. *Commissioner of Internal Revenue* (C. C. A. 3) 56 Fed. (2d) 1021.

new estimates gained from experience with the property. The regulations have consistently required that allowable depreciation be determined "on the basis of facts reasonably known to exist at the end of such year or period."[8] Where, however, on the known facts the amount of depreciation reported in a given year is erroneous, nothing contained in the regulations have prevented the rectification of the error to a taxpayer's basis in the same way that any error in the reporting of a deduction may be corrected. In such event the burden of proof has been on the taxpayer to show that the rates employed or the computation made were, on the then known facts, erroneous and that he did not profit by his mistakes.

In the instant case respondent stipulated that in the prior loss years the rates used by the petitioner were excessive. The parties therefore recognized and agreed that the excess amount of depreciation reported in those years was a mistake. If the petitioner had profited by its mistake or if the respondent in reliance upon the deduction had acted to his prejudice or loss, the petitioner would be estopped to rectify the error. Since, however, it is conceded that such was not the case (in fact respondent has never pleaded an estoppel) there is no rule of law which binds the petitioner to the erroneous deductions reported and prevents the proper adjustment to its base for the purpose of computing the correct amount of current allowable depreciation.

The principle involved in this case is identical with that involved in the case of *Pittsburgh Brewing Company* v.

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[8] Reg. 65, Art. 165.
Reg. 69, Art. 165.
Reg. 77, Art. 205.
Reg. 86, Art. 23 (L)-5.
Reg. 94, Art. 23 (L)-5.
Reg. 101, Art. 23 (L)-5.

Commissioner, 107 F. (2d), 155, although the error in the loss years in that case resulted from a gross error in the basis used and not in the rate. Depreciation is a product of base and rate and an error on either side of the equation has the same practical effect.[9]

It is respectfully submitted that the principle enunciated in the Pittsburgh Brewing case is sound and is applicable to the case at bar. Where none of the elements which customarily combine to spell out an estoppel is present in the case there is no reason for denying to a taxpayer the right to correct an error reported in a prior return. Depreciation charges are not expenses incurred in the ordinary sense, as rent or salaries, but are bookkeeping computations. An error in such a computation which is not prejudicial to the Commissioner, whether it be the result of a mistake in the base or in the rate, should not be deemed a permanent irrevocable charge which is beyond correction. If respondent's interpretation of the law is correct, a taxpayer would be bound by an erroneous depreciation deduction resulting from a mistake in arithmetical computation since, as respondent views the law, by the mere filing of the return the erroneous deduction is deemed "allowed".

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9 When the error is in the base rather than in the rate, as in the Pittsburgh case, the analogy between errors and depreciation deducted and error in valuations used in tax returns is more clearly apparent. No other error in valuation binds a taxpayer in subsequent years, except upon the basis of estoppel. Clearly the general law prior to the enactment of Section 113(b)(1)(B) would not have bound a taxpayer who used a wrong base for depreciation except upon a similar principle, and, as clearly pointed out above, that statute did not mean to bar a taxpayer, except upon some similar principle similar to estoppel.

II

The practical features of the depreciation problem favor the interpretation of Section 113(b)(1)(B) which the Third Circuit employed in the Pittsburgh Brewing case.

1. No Administrative Difficulties Arise by Reason of this Interpretation.

All deductions of whatsoever nature which are reported by a taxpayer, rest on facts which, in the first instance, are within the taxpayer's own knowledge. This is true, for example, respecting deductions involving proof of cost, compensation to officers, bad debts and indeed any ordinary business expense. It does not follow that because the taxpayer prepares his own return, based upon his own knowledge of the facts, that the tendency is to misrepresent or overstate his deductions. Respondent's argument that the position advocated by the petitioner would create an incentive to file false returns and involve the Bureau of Internal Revenue in grave administrative difficulties is largely ephemeral. This is apparent when one considers the administrative practice which maintains in the examination and audit of returns which are likely to involve depreciation problems.

In the administrative practice of the Bureau of Internal Revenue, all individual income tax returns showing gross income of $25,000 or more and all corporate returns showing gross income of $75,000 or more are, except in loss years, sent into the field for examination after the preliminary office audit.[10] Moreover, depreciation is a subject of review by the Engineering & Valuation Division of the Bureau which passes upon the problems raised under T. D.

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[10] *Paul and Mertens, "Law of Federal Income Taxation"*, Vol. 5, Sec. 42.34. *Prentice-Hall, Federal Tax Service,* Par. 18,101.

4422, containing the regulation pertaining to the method and procedure of reporting depreciation deductions.[11]

It is safe to say, therefore, that there are comparatively few income tax returns showing profits, where depreciation deductions are involved, which are not subjected to a field examination by the Bureau. The first profit return of a taxpayer in which a new rate of depreciation is used will invariably be examined by the Bureau. Since the decentralization of the Bureau in 1937, with the resulting establishment in each local district of a separate Valuation Section, the organization for the examination of such returns and the study of depreciation questions has been so thorough that, as a practical problem, the dangers envisioned by the respondent are insignificant.

2. The Necessity for Recomputing Depreciation Frequently Arises and Creates no Difficult Administrative Problem.

Situations are numerous in which it is essential, for the computation of a taxpayer's correct liability, to reexamine the items contained in prior returns. For example, in the Revenue Act of 1942 (Public Law 753, 77th Cong., 2d Sess.), it is provided in Section 116 that recoveries of income with respect to bad debts, prior taxes and delinquency amounts which were charged off in prior years where tax savings were thereby accomplished do not constitute taxable income.[12] Also, in the computation of gain or loss on the sale of depreciable assets, the practice is to disregard all prior deductions and to recompute the correct allowable depreciation for the preceding years. In

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[11] *Paul & Mertens*, Sect. 42.30.

[12] Under section 23(s) and 122(a) and (b) of the Revenue Act of 1942 it may be necessary for the Bureau to re-examine returns for five years in determining the net operating loss deduction resulting from the carry-back and carry-over provisions.

other words, if a taxpayer has taken less depreciation than the amount which was properly allowable to him his base is reduced in such recomputation by the full allowable depreciation. This procedure should be borne in mind when it is argued that the petitioner's contention would result in grave administrative difficulties. It is true also that wherever experience with depreciable assets proves that the rate which was used was either excessive or inadequate, it is necessary to review all prior returns to determine the residual undepreciated cost for the purpose of projecting the same forward over the remaining redetermined useful life of the assets. While such procedure involves detail, it has never proved prohibitive.

3. The Correction of Mistakes in Depreciation Involve no Administrative Problem and Should not be Prohibitive.

As this discussion has illustrated, computation of tax liabilities and the recomputation of depreciation deductions, as well as of the adjusted base of depreciable assets are a commonplace. If, therefore, a taxpayer is able to show that a bona fide mistake was made in the computation of a depreciation deduction reported on his return and that he did not profit by his mistake, the correction thereof by adjustment to his base creates no particular problem for the Bureau.

We are of course not addressing ourselves to the problem of fraudulent returns in which taxpayers with deliberate intent overstate their allowable deductions. Mistakes, however, frequently occur in the determination of basis or of the rate of depreciation or of a mere mathematical computation. If the taxpayer has not been unjustly enriched thereby or is not estopped to make the correction, there is no plausible reason why the adjustment may not be accomplished under normal administrative procedure. In passing, it should be noted that no claim has been made that the computation of the depreciation deduction or the de-

termination of basis or rate upon which such computation is made constitutes an election which, when once made, is irrevocable. Indeed, nothing contained in Section 113(b)(1)(B) or the regulations or the Committee reports would indicate that the amount of depreciation reported represents an election.

III

The analogy drawn by the Fourth Circuit to bad debt recoveries is unsound and its decision should be reversed.

The opinion of the Court below is predicated upon its own prior holding to the effect that recoveries of income on bad debts previously charged off in loss years are taxable. It is then argued analogously by the Court that the question of tax-benefit is alike in depreciation as well as bad debt cases and that consequently a taxpayer's basis must be reduced by all depreciation deductions which have been reported, irrespective of tax-benefit.

This argument, we submit, is unsound and is founded upon a false premise. Depreciation deductions are not wedded to the theory of tax-benefit. Deductions which are properly allowable reduce a taxpayer's base whether such deductions off-set taxable income or not. In drawing an analogy to bad debt recovery cases the lower Court overlooked the very important fact that bad debt deductions are "allowable" deductions and that as such it is wholly immaterial that they have not off-set taxable income. Where a debt is ascertained to be worthless, the investment therein is lost, and therefore it may very well be, as the lower Court has previously held, that the recovery of proceeds therefrom in a later year constitutes taxable income notwithstanding that no tax benefit was realized in the year of deduction. The Treasury has itself had great difficulty

making up its mind on this point.[13] But the analogy is unsound for, as we have pointed out, the case at bar is not concerned with properly allowable deductions. If in *Helvering v. State-Planters Bank & Trust Co.*, 130 Fed. (2d) 44 the taxpayer had taken an *erroneous bad debt deduction* in a loss year would the Fourth Circuit have held that the recovery of the debt in a subsequent year constituted taxable income? In that situation a parallel to the instant case might have existed. We are here dealing with an erroneous deduction and not, as in the *State-Planters* case, with a properly deducted bad debt in the year of ascertainment.

Allowable depreciation, as the petitioner concedes in the case at bar and as was conceded in the *Pittsburgh Brewing* case, must be deducted from basis even though it does not off-set taxable income. But where a mistake has been made in the computation of depreciation and the taxpayer has not profited by his mistake, neither the statute nor any known legal theory requires that the error be perpetuated and prevents its due correction.

In the Revenue Act of 1942 the Congress gave recognition to the fact that in the bad debt cases it was inequitable to charge a taxpayer with the receipt of taxable income where the deduction of the bad debt in a prior year did not off-set taxable income and even though the deduction in the prior year was proper or "allowable". In view of the Treasury's own vacillation on this subject and the confusion which it had created, the enactment seems to have had the purpose of setting that troublesome problem at rest on equitable principles.

On the subject of erroneous excess depreciation, however, existing legal principles were adequate for the purpose of reaching a just result and the courts had uni-

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[13] G. C. M. 18525, C. B. 1937-1, p. 80.
G. C. M. 20854, C. B. 1939-1, p. 102.
G. C. M. 22163, C. B. 1940-2, p. 76.

formly held prior to the enacting of the Revenue Act of 1942 that where on the known facts an error had been made, that error might be corrected if the taxpayer was not estopped to do so. Since the Congress saw fit to provide that even where an *allowable* bad debt deduction had been taken no taxable income is realized in the year of recovery unless a tax benefit had been obtained in the loss year, it is inconceivable that, in the face of existing judicial authority, it intended to discriminate against taxpayers who had made a mistake in loss years and deny to them the right, which is available respecting other ordinary deductions, to rectify the error.

Respectfully submitted,

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SUPREME COURT OF THE UNITED STATES.

No. 766.—October Term, 1942.

Virginian Hotel Corporation of Lynchburg, Petitioner, *vs.* Guy T. Helvering, Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Fourth Circuit.

[June 7, 1943.]

Mr. Justice Douglas delivered the opinion of the Court.

The facts of this case are stipulated. Petitioner operates an hotel. From 1927 through 1937 petitioner (or its predecessor) reported in its income tax returns depreciation on certain of its assets on a straight line basis.[1] No objection was taken by the Commissioner or his agents to the amounts claimed and deducted. In 1938 petitioner claimed a deduction for depreciation at the same rates. The Commissioner determined that the useful life of the equipment was longer than petitioner claimed and that therefore lower depreciation rates should be used.[2] Accordingly a deficiency was computed. The depreciation theretofore claimed as deductions was subtracted from the cost of the property. The remainder was taken as the new basis for computing depreciation. A lesser deduction for depreciation accordingly was allowed.[3] There had been a net gain for some of the years in question. For the years 1931 to 1936 inclusive there was a net loss and, says the stipulation, "the entire amount of depreciation deducted on the income tax returns for those years did not serve to reduce the taxable income." Petitioner does not challenge the new rates. It contends that the amount of depreciation claimed for the years 1931 to 1936 inclusive in excess of the amount properly allowable should not be subtracted

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1 15% on carpets and 10% on all other equipment. At those rates the properties would have been fully depreciated in 6⅔ and 10 years respectively.

2 8% on carpets and 5% on the other equipment, the estimated life being 12½ years and 20 years respectively.

3 $1,295.47 for 1938 as compared with $4,341.97 which was claimed. The difference between the depreciation claimed in the loss years and the depreciation properly allowable in such years is $31,400.25.

from the depreciation basis, since it did not serve to reduce taxable income in those years. The Tax Court in reliance on an earlier ruling[4] held for the petitioner. The Circuit Court of Appeals reversed. 132 F. 2d 909. The case is here on a petition for a writ of certiorari which we granted because of a conflict between the decision below and *Pittsburgh Brewing Co.* v. *Commissioner,* 107 F. 2d 155, decided by the Circuit Court of Appeals for the Third Circuit.

A reasonable allowance for depreciation is one of several items which Congress has declared shall be "allowed" as a deduction in computing net income. Int. Rev. Code § 23(1). The basis upon which depreciation is to be "allowed" is the cost of the property with proper adjustments for depreciation "to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws."[5] That provision makes plain that the depreciation basis is reduced by the amount "allowable" each year whether or not it is claimed. *Fidelity-Philadelphia Trust Co.* v. *Commissioner,* 47 F. 2d 36. Moreover the basis must be reduced by that amount even though no tax benefit results from the use of depreciation as a deduction. Wear and tear do not wait on net income. Nor can depreciation be accumulated and held for use in that year in which it will bring the taxpayer the most tax benefit. Congress has elected to make the year the unit of taxation. *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359. Thus the amount "allowable" must be taken each year. *United States* v. *Ludey,* 274 U. S. 295, 304.

But it is said that "allowed" unlike "allowable" connotes the receipt of a tax benefit. The argument is that though depreciation in excess of an "allowable" amount is claimed by the taxpayer and not disallowed by the Commissioner, it is nevertheless not "allowed" if the deductions other than depreciation are sufficient to produce a loss for the year in question. "Allowed" in this setting plainly has the effect of requiring a reduction of the depreciation basis by an amount which is in excess of depre-

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[4] Kennedy Laundry Co. *v.* Commissioner, 46 B. T. A. 70, which followed Pittsburgh Brewing Co. *v.* Commissioner, 107 F. 2d 155. Prior to the Kennedy Laundry Co. case and prior to the time when Pittsburgh Brewing Co. *v.* Commissioner, 37 B. T. A. 439, was overruled, the Tax Court took a contrary view. Its decision in the Kennedy Laundry Co. case was reversed by the Circuit Court of Appeals. 133 F. 2d 660.

[5] Sec. 113(b)(1)(B) which is made applicable by reason of § 23(n), § 114, and § 113(a).

ciation properly deductible. We do not agree, however, with the contention that such a reduction must be made only to the extent that the deduction for depreciation has resulted in a tax benefit. The requirement that the basis should be adjusted for depreciation "to the extent allowed (but not less than the amount allowable)" first appeared in the Revenue Act of 1932. 47 Stat. 169, 201. Prior to that time the adjustment required was for the amount of depreciation "allowable".[6] The purpose of the amendment in 1932 was to make sure that taxpayers who had made excessive deductions in one year could not reduce the depreciation basis by the lesser amount of depreciation which was "allowable". If they could, then the government might be barred from collecting additional taxes which would have been payable had the lower rate been used originally.[7] But we find no suggestion that "allowed", as distinguished from "allowable", depreciation is confined to those deductions which result in tax benefits. "Allowed" connotes a grant. Under our federal tax system there is no machinery for formal allowances of deductions from gross income. Deductions stand if the Commissioner takes no steps to challenge them. Income tax returns entail numerous deductions. If the deductions are not challenged, they certainly are "allowed" since tax liability is then determined on the basis of the returns. Apart from contested cases, that is indeed the only way in which deductions are "allowed". And when all deductions are treated alike by the taxpayer and by the Commissioner, it is difficult to see why some items may be said to be "allowed" and others not "allowed".[8] It would take clear and compelling indications for

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6 For a summary of the legislative history, see 40 Col. L. Rev. 540.

7 S. Rep. No. 665, 72d Cong., 1st Sess., p. 29: "The Treasury has frequently encountered cases where a taxpayer, who has taken and been allowed depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact 'allowable' were much less. By this time the Government may be barred from collecting the additional taxes which would be due for the prior years upon the strength of the taxpayer's present contentions. The Treasury is obliged to rely very largely upon the good faith and judgment of the taxpayer in the determination of the allowances for depreciation, since these are primarily matters of judgment and are governed by facts particularly within the knowledge of the taxpayer, and the Treasury should not be penalized for having approved the taxpayer's deductions. While the committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility."

8 As we have noted, the stipulation of facts states that "the entire amount of depreciation deducted on the income tax returns" for the years in question "did not serve to reduce the taxable income." That has been taken to mean

us to conclude that "allowed" as used in § 113(b)(1)(B) means something different than it does in the general setting of the revenue acts. See *Helvering* v. *State-Planters Bank & Trust Co.*, 130 F. 2d 44.

Congress has provided for deductions of annual amounts of depreciation which, along with salvage value, will replace the original investment of the property at the time of its retirement. *United States* v. *Ludey, supra; Detroit Edison Co.* v. *Commissioner*, 318 U. S. —. The rule which has been fashioned by the court below deprives the taxpayer of no portion of that deduction. Under that rule taxpayers often will not recover their investment tax-free. But Congress has made no such guarantee. Nor has Congress indicated that a taxpayer who has obtained no tax advantage from a depreciation deduction should be allowed to take it a second time. The policy which does not permit the second deduction in case of "allowable" depreciation (*Beckridge Corp.* v. *Commissioner*, 129 F. 2d 318) is equally cogent as respects depreciation which is "allowed".

Affirmed.

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that no part of the depreciation deduction resulted in tax benefits. We do not stop to inquire how that could be true when the depreciation deducted on each return from 1931 through 1936 was larger than the net loss for each of those years. If the stipulation were not accepted, one other problem would be presented. That is the theory that when there is a loss, depreciation may be singled out as not offsetting gross income even though it is only one of several deductions which is claimed. See Kennedy Laundry Co. *v.* Commissioner, 46 B. T. A. 70, 75, Judge Disney dissenting. In view of the stipulation we do not reach that question. Cf. Butler Bros. *v.* McColgan, 315 U. S. 501, 508-509.

Mr. Chief Justice STONE, dissenting.

It is true that the 1938 Revenue Act does not speak of a "tax benefit" to the taxpayer. Section 23 speaks only of deductions from gross income which "shall be allowed" in computing net income, among which it includes, § 23(l), 'a reasonable allowance for the exhaustion, wear and tear of property used in trade or business". And by § 113(b)(1)(B) the basis for depreciation of property is its cost adjusted by depreciation "to the extent allowed (but not less than the amount allowable)". It is equally

true and obvious, and of some importance to the correct interpretation of the statute, that any depreciation in excess of the reasonable allowance authorized can, under the statute, result in no tax advantage to the taxpayer and in no tax prejudice to the Government, unless the excess has in fact been deducted from the taxpayer's gross income.

I can find no warrant in the purpose or the words of the statute, or in the principles of accounting, for our saying that the taxpayer is required to reduce his depreciation base by any amount in excess of the depreciation "allowable", which excess he never has in fact deducted from gross income. Whatever else the statutory reference to depreciation "allowed" may mean, it obviously cannot and ought not to be construed to mean that a deduction for depreciation which has never in fact been subtracted from gross income is a deduction "allowed".

And there is no reason why such should be deemed to be its meaning. The only function of depreciation in the income tax laws is the establishment of an amount, which may be deducted annually from gross income, sufficient in the aggregate to restore a wasting capital asset at the end of its estimated life. The scheme of the 1938 Revenue Act is to prescribe the permissible deductions for depreciation, and to preclude the taxpayer from gaining any unwarranted advantage by the amount and distribution of those deductions. The Act accomplishes the latter by compelling the taxpayer to reduce his depreciation base by the amount of the allowable annual depreciation, whether deducted from gross income or not, and by such further amount as he has in fact deducted from gross income. No reason is suggested why the taxpayer's tax for future years should be increased by reducing his depreciation base by any amount in excess of the depreciation "allowable", unless the excess has at some time and in some manner been deducted from gross income. So inequitable a result cannot rightly be achieved by saying that a "deduction" for depreciation which never has been deducted from gross income has nevertheless been "allowed".

What I have said does not imply that a taxpayer, who has deducted excessive depreciation from his gross income in any year, is not subject to a deficiency assessment as the statutes and regulations prescribe; or that excessive deductions for depreciation taken from gross income—or allowable depreciation, whether

so deducted or not—may not properly be used to reduce the taxpayer's depreciation base. The statute so provides. But I do assert that, under the system of taxation which we have established, the overstatement of the taxpayer's depreciation base on which the Government insists is not to be justified because the taxpayer may in some other year have deducted from gross income excessive depreciation which has already been subtracted from his depreciation base. See *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 365. The statute neither compels nor permits so incongruous a result. The judgment should be reversed.

Mr. Justice ROBERTS, Mr. Justice MURPHY and Mr. Justice JACKSON join in this dissent.

Mr. Justice JACKSON, dissenting.

The first and fundamental step in determining accrued depreciation is to estimate the probable useful life of the property to be depreciated. This depends upon judgment and is not capable of exact determination. When it is found, and after making allowance for probable salvage value at the time of retirement, it is a mere matter of mathematics to compute under the straight-line method the rate of annual accrual.

This rate when applied to the cost of the depreciable property fixes two things: (1) The amount of the depreciation accrual to deduct from gross, before determining net, income. For this purpose a high rate works in favor of the taxpayer for any given year. (2) It also determines the amount by which the cost base must be reduced for application of depreciation rates the following year. In this aspect a high depreciation rate works in favor of the Government.

The Virginian Hotel Corporation misconceived, as the Commissioner thinks, the probable life of its depreciable property. Attributing to it a longer life span, he corrected that judgment. To apply that correction consistently would lower the rate and consequent deduction on account of depreciation and cause a smaller subtraction from the valuation base, leaving a larger base to which the smaller rate would be applied.

The Commissioner proposed to correct taxpayer's returns by considering only the year in question. He eliminated the error

as far as it affected the rate and thus reduced the depreciation accrual and increased the tax. But he retained the base as reduced by the taxpayer's accumulated errors, refusing to readjust the base consistently with the corrected depreciation rates.

To the extent that the taxpayer had obtained advantage from the use of the higher depreciation rate, I would think it quite justifiable to refuse to make a correction. The Government, however, stipulates as to the years in question that "the entire amount of the depreciation deducted on the income tax returns for those years did not serve to reduce the taxable income." We should not disregard a deliberately made stipulation, even if, on our limited knowledge of its background, we are in doubt as to why it was made. The question comes simply to this: Whether the Commissioner, upon determining whether taxpayer has in good faith erred, may use a correction in so far as it helps the Government and adhere to the mistake in so far as it injures the taxpayer. I think that no straining should be done to find a construction of the statutes that will support the result.

I am the less inclined to lay down a rule that will permit the Government to make inconsistent corrections in the matter of depreciation because consistency in the matter of depreciation is one of the few important principles of its application. There has been no more futile tax litigation than that over depreciation rates. In an era of rising taxes the faster a taxpayer depleted his base for depreciation the more the Government realized in revenue from him. If this present taxpayer had been permitted to continue its high depreciation rates, it would have come into the present era of exceedingly high taxes with its depreciation base correspondingly exhausted. What is important for the protection of the revenues is that accrual for depreciation be applied only to property that is properly depreciable, that it be stopped when the property is fully depreciated, and that the rate be consistently applied so that the taxpayer cannot choose to take only a little depreciation when he has a little income and a lot of depreciation when he has a large income. If these conditions are observed, litigation about the rate serves chiefly to vindicate theories rather than to protect the revenues.

If the Government desires to make revisions of theoretical rates, there is no reason why it should not observe the rule of consistency that is one of the cardinal rules to impose on the taxpayer. Hence, I join in the dissenting opinion of the CHIEF JUSTICE.